



*Andrew Junkin  
CFA, CIMA, CAIA  
Managing Director*

July 19, 2006

Mr. Russell Read  
Chief Investment Officer  
California Public Employees' Retirement System  
400 Q Street  
Sacramento, CA 95814

Re: Self-Funded Healthcare Plan Investment Policy Revision

Dear Russell,

You requested Wilshire's opinion with respect to Staff's proposed revision of the Self-Funded Healthcare Plan's Statement of Investment Policy to change the benchmark from a short-term fixed income benchmark to an intermediate-term fixed income benchmark. Wilshire agrees with the benchmark recommendation and the proposed policy changes to allow Staff to manage the portfolio effectively against the new benchmark.

### **Background**

The Self-Funded Healthcare Plan has consistently had a surplus of funds on hand over the past several years which has been invested in a fixed income portfolio with a very short duration benchmark. These surplus funds have been in excess of \$300 million and are above the operating cash needs of the Fund. This short-term benchmark has caused the portfolio to be managed with a focus of safety of principal and Staff has invested accordingly. By limiting the portfolio's duration and by focusing on safety, the portfolio has had a lower return than would likely have been achieved with a slightly longer duration benchmark. Investment Staff proposed changing the benchmark to a longer duration benchmark that would allow the portfolio to be managed for higher yield and total return. One potential benefit of the increased return would be a lower cost to the participants in the Self-Funded Healthcare Plan.

### **Discussion**

Wilshire met with Investment Staff and Healthcare Staff to discuss the potential risks and rewards associated with lengthening the duration of the portfolio. After discussing a number of benchmark options, Staff decided that the most appropriate benchmark for these surplus funds was the Lehman Aggregate Index. Wilshire agrees with this

## Self Funded Health Care Plan Policy Revision

July 19, 2006

Page 2

conclusion. Currently, the Lehman Aggregate index has a duration of approximately 4.8 years and is one of the broadest representations of the investment grade fixed income market. Wilshire's long term forecast of returns for the Lehman Aggregate Index is 5.0%, which compares favorably with the long term forecasted returns of 3.0% for short duration fixed income.

Staff and Wilshire discussed the risks of having a longer duration portfolio: chiefly, the effect of rising interest rates. Given the steady nature of the surplus funds (Healthcare Staff indicated that the amount of surplus funds had not fallen below \$300 million in the past 18 months or so) Staff feels that the volatility associated with the longer duration portfolio is manageable. In addition, Healthcare Staff does not intend to commit all of these surplus funds to the longer duration portfolio. Rather, the longer duration portfolio is expected to start with a value of \$250 million, with the remainder of the surplus funds held in a short duration, liquid vehicle (similar to CalPERS High Quality LIBOR fund).

Investment Staff has demonstrated the ability to manage a variety of fixed income portfolios successfully. This portfolio will be similar to the CalPERS Dollar-Denominated Fixed Income portfolio, but will have a shorter duration target (Lehman Aggregate versus Lehman Long Liability). Staff has demonstrated expertise in the sectors that will comprise the portfolio: corporate bonds, agency bonds, treasury bonds, securitized bonds and opportunistic bonds.

### **Conclusion**

Wilshire agrees with Staff's recommendation to change the benchmark for the surplus funds for the Self-Funded Healthcare Plan to the Lehman Aggregate Index. This will allow the Fund to benefit from the greater return associated with the longer duration of the portfolio and Wilshire believes Staff understands, has taken steps to mitigate and will continually manage the risk associated with the increased duration. We have reviewed the revised Policy and feel appropriately addresses the guidelines, objectives and roles and responsibilities of a portfolio managed against the Lehman Aggregate Index.

If you have any questions, please let me know.

Best regards,

A handwritten signature in dark ink, appearing to read "Dan Jiri", is located at the bottom left of the page.